

## Internal Revenue Service

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PLR-127482-06

Date:

September 19, 2006

### Legend

Trust =

District Y =

State X =

Collective Bargaining Unit Z =

System =

Agreement A =

Trust Agreement =

Dear :

This is in response to a letter dated May 23, 2006, and subsequent correspondence, submitted by the Trust, requesting rulings that the Trust's income is excludable from gross income under section 115(1) of the Internal Revenue Code (Code), and that the Trust has no federal income tax return filing obligation.

FACTS

Taxpayer has made the following representations of facts. Y, a Public School District of X, and Z, the collective bargaining unit of Y's teachers, formed the taxpayer (the Trust). The Trust is organized under the laws of State X to hold and invest property tax revenues designated for payment of compensation to the teachers of Y who opt into an alternative compensation system (the System). An agreement executed between Y and Z (Agreement A), the ballot language approved by the voters, and the goals of the System govern the employment terms, conditions, and entitlements of the teachers who opt into the System.

The Trust will operate in accordance with the terms, provisions, and conditions set forth in the Trust Agreement adopted by Y and Z. Y will fund the Trust with the proceeds from a levy approved by the voters of Y and may earmark and transfer additional funds to the Trust. All payments out of the Trust will be made only in accordance with the terms and conditions set forth in Agreement A and the Trust Agreement. The Trust will transfer to Y the amount of Y's monthly payroll obligation to the teachers who opt into the System. Y will return to the Trust any excess payments as soon as feasible. The Trust will invest the remaining funds and use them together with any income to satisfy Y's future payroll obligations to the teachers who opt into the System.

The Trust's funds, including its income, will be permanently dedicated solely for the payment of compensation to the teachers of Y who opt into the System and reasonable and necessary expenses associated with administration of the Trust. The board of trustees will be comprised of three representatives of Y, three representatives of Z, and two representatives of the community. The trustees will have the exclusive authority and responsibility over custody and management of the Trust. This authority may be delegated as provided in the Trust Agreement.

The Trust Agreement provides that upon termination of the Trust, its assets will be used to pay obligations of the System and the remaining assets will be distributed and allocated in accordance with the terms of Agreement A and the Trust Agreement. The trustees propose the following amendment to the Trust Agreement "[i]f any assets remain in the Trust upon dissolution of the Trust, those assets may in no event be distributed to any person or entity other than an organization the income of which is excluded from gross income under Internal Revenue Code section 115(1) (dissolution clause amendment).

## LAW AND ANALYSIS

Section 115(1) of the Internal Revenue Code excludes from gross income any income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia.

In Rev. Rul. 77-261, 1977-2 CB. 45, the Service ruled that a corporation derives income from the exercise of an essential government function where a state or its political

subdivision invests funds through a corporation, which is a separate entity from the state or political subdivision. The ruling explains that investment of positive cash balances by a state or political subdivision in order to receive some yield on the funds is a necessary incident of the power of the state or political subdivision to collect taxes and other revenues for use in meeting governmental expenses. Id. Further, the ruling provides that this determination must be based on all facts and circumstances of each case. Id.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service ruled that a corporation's income accrues to a political subdivision of a state where a corporation is organized to pool county governments' casualty risks and the income is used to reimburse casualty losses incurred by the county governments. The Service ruled that the corporation's income is used to meet governmental obligations and any private benefit to the recipients of insurance proceeds was incidental to the public benefit.

In Rev. Proc. 2003-12, 2003-1 C.B. 316, the Service explained that the distribution upon dissolution requirement is an aspect of the accrual test. Essentially, upon dissolution of an organization the income of which is excludable under section 115(1), the assets must be distributed to one or more states, political subdivisions thereof, the District of Columbia, or other organizations the income of which is excluded from gross income under §115(1).

Pursuant to Rev. Rul. 77-261 and Rev. Rul. 90-74, the Trust derives income from the exercise of an essential government function. It is a separate entity from X and Y. It is organized for the purpose of holding and investing funds specifically designated for meeting Y's obligation to pay compensation for the teachers of Y who opt into the System. As Agreement A and the Trust Agreement provide, except for the payment of reasonable and necessary expenses associated with the Trust's administration, the Trust's funds and income will be used solely for the purpose of meeting future governmental expenses.

Upon adoption of the dissolution clause amendment, the Trust's income will accrue to Y, a political subdivision of X. See Rev. Proc. 2003-12. As is in Rev. Rul. 90-74, the Trust's income will be used for public benefit, i.e., to satisfy Y's payroll obligations to the Y's teachers who opt into the System. Any private benefit to the Y's teachers will be merely incidental to the public benefit.

Section 6012 and the regulations thereunder, require every corporation subject to taxation under subtitle A of the Code to make a return of income. If a trust is classified as a corporation under section 7701(a)(3), section 6012 requires the trust to file income tax returns regardless of whether the trust's income is excludable under section 115(1). See Rev. Rul. 77-261.

Section 6012(a)(4) of the Code provides that a trust must file income tax returns if for the taxable year it has any taxable income or has gross income of \$600 or more.

Section 7701(a)(1) and section 301.7701-4(a) of the Procedure and Administration Regulations define a trust for purposes of section 6012(a)(4). If an entity meets the requirements of a trust, and all of its income is excluded from gross income under section 115(1), it will have no taxable income or gross income and, therefore, no income tax return filing obligation.

Provided that the Trust amends the dissolution clause, as of the date of the amendment, all of its income will be excludable from gross income under section 115(1). If the Trust is classified as a trust under section 7701(a)(1), then the Trust will have no obligation to file information returns under section 6012(a)(4).

Any income that the Trust earned from the date of its formation to the effective date of the dissolution clause amendment is not excludable from the Trust's gross income under section 115(1) because the Trust did not satisfy the accrual test. Additionally, for that time period, the Trust, even if classified as a trust under section 7701(a)(1), may have an obligation to file income tax returns under section 6012(a)(4).

#### HOLDINGS

Based on the information submitted, we conclude, contingent upon the Trust's adoption of the dissolution clause amendment, as of the date of the amendment, the Trust's income is excludable from gross income of the Trust under section 115(1) of the Code. If the Trust is classified as a trust under section 7701(a)(1), the Trust has no federal income tax return filing obligation under section 6012(a)(4).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

David L. Marshall  
Chief, Exempt Organizations  
Branch 2  
Division Counsel/Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosures:

Copy of this letter  
Copy for § 6110 purposes